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Un-MECing a MEC

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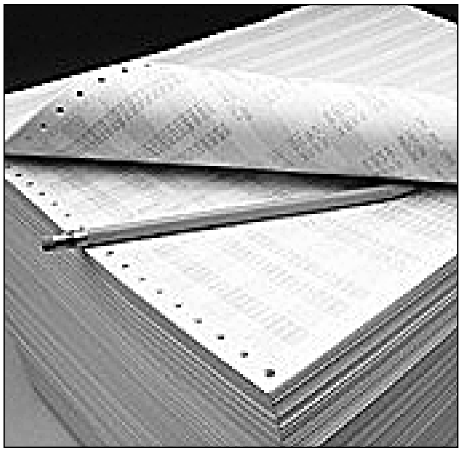
Can a recently issued IRS revenue procedure reduce potential market conduct issues related to inadvertent Modified Endowment Contracts ("MECs")? For some companies, the answer is "yes," and this could be the time to "un-MEC a MEC." These inadvertent MEC's are of concern because of the potential for adverse policyholder taxation related to distributions. They are often discovered after policies are converted to a more sophisticated administrative system or during due diligence activities for acquisition candidates. Unlike the procedures in place to cure a failure of the definition of life insurance (as defined in Internal Revenue Code section 7702), prior to this new revenue procedure, there were no procedures to restore non-MEC status to policies that have been MECs for a period extending beyond the 60-day window for returned premiums.

Revenue Procedure 99-27 permits a life insurance company to remedy an inadvertent and non-egregious failure to



comply with the modified endowment contract ("MEC") rules under section 7702A of the Internal Revenue Code ("Code"). Submitting a request for ruling with a proposed closing agreement to the IRS initiates the formal process of restoring non-MEC status. Additionally, the issuing company must pay a toll charge to cure the contract, which includes imputed tax charges on overage earnings and distributions plus deficiency interest attributable to distributions. Pursuant to the closing agreement, the issuer agrees to bring the contracts into compliance with Code section 7702A by an increase in death benefit or the return of excess premiums with earnings thereon.

Overview of Section 7702A

A MEC is a life insurance contract that satisfies the federal tax definition of a life insurance contract under Code section 7702, but fails to satisfy a "7-pay" test under Code section 7702A. To reduce the ability of life insurance contracts to serve as investment vehicles, Congress established limits on the pre-funding of contractual future benefits. If the accumulated premiums paid at any time during the first seven contract years exceed the cumulative 7-Pay Premiums, the contract is classified as a MEC. However, life insurance contracts that were never designed with a heavy investment orientation may inadvertently fail the 7-pay test due to a variety of reasons, such as Code section 7702A's complex calculations, its reliance on error-free administrative systems, or unscheduled premium payments.

If a contract fails the 7-pay test and is a MEC, actual distributions and deemed distributions (e.g., policy loans) are subject to the same income-out-first rules that are applicable to annuities. This treatment compares poorly to the general rule for non-MEC life insurance contracts under which borrowings do not create income and distributions are taxed on an income-out-last basis. Additionally, a MEC distribution is usually subject to an additional tax under Code section 72(v) of 10% of the includible income amount, unless the policyholder qualifies for one of several exceptions; e.g., age 59½ or older. Other than these distribution rules, MEC status does not alter the general tax principles

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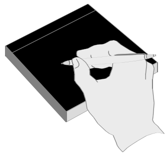
policy on a guaranteed basis for flexible premium contracts. This is not the case for a fixed premium contract—there the GMP is actual fixed premium.

For a fully flexible premium contract, the GMP, by regulation, would not be affected by GAP, as I read the plain words of the Regulation. The concept of premium limits on a flexible contract is not a new one, and the drafters of the UL Model Regulation would have had every opportunity to cap the GMP at maximum permitted premium if they had so wished or thought of the issue.



On the other hand, it certainly is peculiar to premise the valuation on a premium greater than is either permitted or is at all likely to be paid because of compelling tax reasons.

As Mr. Hippen points out, the effects of a cap on GMP could be complex and unintuitive. I suspect that in the garden-variety case where mortality is the same on GAP and guarantees, and interest is higher on GAP than on guarantees, that the cap would produce slightly higher reserves, as the effect of valuing at a higher interest rate will be muted as the plan of insurance valued is changed from whole life to a long-period term coverage.

We invite your opinions and comments on current practices on the issue of capping the GMP by premium limits.

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applicable to life insurance contracts, such as the tax-free death benefit.

Prior to the release of Rev. Proc. 99-27, the only way to cure an inadvertent overfunding error that created MEC status was to return the excess premium with interest to the policyholder within 60 days after the contract year. The tightness of this rule provided insurers with limited means to correct a funding problem and to return a contract to non-MEC status. Another approach was to rescind the contract, tax all the gain and start over, clearly not an appealing option.

Basic Elements of Rev. Proc. 99-27

The voluntary corrections program adopted by Rev. Proc. 99-27 to return a MEC to non-MEC status has been designed with the following administrative objectives and efficiencies:

➢ The procedure does not rule on MEC status, but corrects the errors of contracts admitted by the issuer to be MECs. Hence, the applicant must admit the error.

➢ The request for a closing agreement must be filed by May 31, 2001.

➢ The procedure is available to a broad variety of insurance contracts but contracts with intentional or egregious failures (e.g., those designed to be a MEC or those deemed by the IRS to have an excessive investment orientation) are not eligible. The revenue procedure supplies three examples of ineligible situations. The degree of reasonableness associated with the failure does not appear to be a relevant factor. Corporate-owned policies, except for those insuring a "key person," are also excluded.

➢ The procedure is available to insurers, not policyholders

➢ A toll charge consisting of the following amounts is imposed, where applicable:

- Charge on overage earnings
- Tax on actual or deemed distributions plus deficiency interest
- Additional 10% tax on actual or deemed distributions plus deficiency interest

➢ The earnings from excess premium ("overage earnings") is determined by simple formulae that assume proxy earnings rates for general and separate account funds, rather than the actual earnings rate for each contract. To both the company and the IRS, this approximation avoids the administrative complexity associated with determination of the investment earnings for each contract.

➢ Civil penalties for the failure of the issuer to satisfy reporting, withholding, and/or deposit requirements will be waived.

➢ The toll charges and additional amounts paid by the issuer to bring the contracts into compliance are not deductible, refundable or creditable in any way by the issuer, and do not adjust the contract holder's investment in the contract (i.e., basis).

➢ Relief under the revenue procedure cannot be requested periodically or gradually. Except as otherwise provided, the insurer must submit all affected contracts at one time.

➢ The MEC will be cured and restored to compliance once the insurer takes corrective action by either increasing the death benefit or returning any remaining excess premium with interest thereon to the policyholder.

Computation of the Toll Charge

The toll charge imposed to cure the contract consists of the following amounts:

➢ A charge on overage earnings designed to tax excessive or inappropriate inside build-up

➢ A tax on actual or deemed distributions which substitutes for the income tax that would have been due by the policyholder

➢ Additional tax on actual or deemed distributions, i.e., the 10% penalty tax, if applicable

➢ Deficiency interest on taxes associated with distributions

For all contracts the tax on overage earnings is equal to the product of the following four items:

- Overage (i.e., Excess Premium)
- Specified Earnings Rate
- Applicable Percentage (i.e., Imputed Tax Rate)
- Distribution Frequency Factor

The overage (i.e., excess premium) is determined for each policy for each calendar year and equals the excess of the cumulative amounts paid over the cumulative 7-pay premiums during the "testing period" (i.e., the 7-year period described in Code section 7702A(b) or the additional period required under Code section 7702A(c)(3) if the contract undergoes a material change).

The specified earnings rate for each calendar year is different for general and separate account contracts. For general account contracts, the earnings rate for a contract year is equal to the arithmetic average of the of the monthly interest rates described as Moody's Corporate Bond Yield Average - Monthly Average Corporates for the calendar year in which the contract year begins. The rates from 1991 to 1997 are published in the revenue procedure and vary from 7.5% to 9.2%.

The IRS selection of the formula for determining the earnings rate for separate account contracts appears to have considered the fact that (a) investments in these contracts are typically a combination of equities and fixed income investments, (b) the contracts typically have a general account option, and (c) the rates of return are lower than pure investment products due to various charges applicable to a variable contract. The separate account specified rates are published in the revenue procedure and range from negative 1% in 1994 to 25.4% in 1991. For post 1998 years, the separate account rate is equal to 10% of Moody's Corporate Bond Average plus 90% of an adjusted blended rate composed of the S&P 500 Total Return Index and the Merrill Lynch Corporate Bond Master Bond Index, less a spread.

The earnings associated with the overage are referred to as the "overage earnings" and are equal to the overage for the contract year plus cumulative overage earnings for all prior contract years multiplied by a specified earnings rate. The overage earnings that are calculated during the testing period appear to terminate at the end of the seventh contract year, although that is not entirely clear from the revenue procedure. That is, an overfunding of the contract after the end of the testing period should not result in overage earnings, and the carryover of cumulative prior period overage earnings should terminate.

The graduated applicable percentages (i.e., the imputed tax rates of 15%, 28% and 36%) are based on the size of the death benefit and appear to assume that life insurance contracts with higher death benefits are more likely to be owned by individuals in a higher income tax bracket.

The purpose of the distribution frequency factor is to address the likelihood of policy loan or withdrawal activity based on contract design. If a MEC owner does not borrow against or withdraw money from the contract, there is no income tax liability. To reflect this concern and to reduce the harshness of taxing excess investment earnings that may otherwise never be subject to tax, the IRS established a 0.8 factor (e.g., a 20% reduction) for certain specified contracts and a 0.5 factor for all other contracts. It is unclear if the established factors constitute an equitable convention.

Potential Concerns

The goal of Rev. Proc. 99-27 is to promote voluntary compliance in an administratively simple manner at a cost that is not punitive. However, there are at least three areas that may need further development or comment.

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The first area of concern is the one-shot only relief allowed to an issuer, notwithstanding the IRS's discretion to permit exceptions. The exception examples do not cover assumption reinsurance transactions after a closing agreement is obtained, nor contracts that inadvertently become MECs subsequent to the closing agreement.

Secondly, the method created by the IRS for calculating overage earnings assumes that a significant portion of earnings are accrued for an entire calendar year, even if the overage existed only for a short period. Actual payment dates are ignored. This may unfairly create disproportionately high toll charges in many accounts that become overfunded for a short period of time as a result of early payments of an annual premium.

A third area of concern is the appropriateness of the method of selecting the distribution frequency factor. It appears that substantially all contracts may fall into the 0.8 factor category (i.e., a 20% reduction). One situation in which the distribution frequency factor is 0.8 is where any portion of a policy loan interest rate is guaranteed to be no more than 1% higher than the contract's crediting rate on borrowed funds. Many universal life policies include such a provision.

Furthermore, the distribution frequency factor also is 0.8 if the contract holder has an option to make a partial withdrawal of cash value that reduces the contract's death benefit by a percentage that is less than the percentage reduction in the contract's cash value. It appears that the mathematical formula prescribed for this purpose will capture substantially all contracts that permit partial withdrawals. It is not clear if that is the intended result.

Conclusion

Regardless of its strong or weak points, the MEC correction of errors program provides much needed guidance to life insurers that have issued or acquired inadvertent MECs. Without Rev. Proc. 99-27, companies had little or no viable alternatives to cure MEC problems. Once companies and their advisers begin working with the procedure, it is certain that many questions and issues will arise. It is hoped that life insurers and the IRS will continue to exchange knowledge and experience under the program and that modifications be made, where appropriate. The purpose of a voluntary compliance program is to encourage taxpayers to come forward and not to impose sanctions that outweigh the severity of the noncompliance event.

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